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CURRENCIES AND CREDIT MARKETS

No.199/ November, 1989

Just 40 years after being flattened and dismembered, West Germany has become the economic powerhouse of Europe. Rich, industrious and energetic, it has conquered Western Europe's markets and has penetrated deep into the economies of the East. Bonn is well prepared to play the dominant role in the reconstruction of countries behind the fast-vanishing Iron Curtain.

Amit Roy, Sunday Times
November 12, 1989, London

HIGHLIGHTS

Economic and financial implications of the recent events surrounding East and West Germany have been grossly misinterpreted. The inflation scare-mongering and DM bashing couldn't be more ridiculous.

The relationship between credit and savings now faces the most critical imbalance ever seen in the United States and several other countries. Yet, the familiar inflation symptom of rapidly rising price indexes has generally been missing. Why?

The overall growth in credit and debt provides the most illuminating answer. There are two reasons for that persuasion: first, because credit is the driving force behind money growth; and second, because it is the only aggregate that can provide insight into the question of where the borrowing excesses have imparted their overheating boom.

Principally, new money can be spent in three different ways: on current goods and services domestically, capital assets (real or paper), and on foreign goods or capital assets. Whichever the primary channel, that also determines where the major distortions of inflation will be found and where one can look for the inevitable busts to follow later.

All this leads to one indelible conclusion. The diversion of credit inflation into U.S. financial markets since 1984, and the export boom of 1987/88, have created both a mirage and a false sense of security about U.S. economic and financial strength.

It's no surprise that the popular mythology of a "perpetual soft landing" - like a lifeboat in a sea of grasping economic illiteracy - has found a clinging majority of hopeful adherents. The whole concept is based on an illusion caused by asset inflation and non-recurring external economic factors.

It is a fact that all cyclical upswings caused by monetary inflation start with rising asset prices, just as all recessions begin with falling prices. The only thing new in the U.S. experience presently, is that a widespread collapse in property prices has occurred without a visible credit crunch. In the meantime corporate profits have begun their collapse.

Frightening as all these trends are, they become quite ominous when one realizes that all this is occurring while the economy is still expanding. One can only wonder what will happen to profits and asset prices should production and sales actually decline...even if only moderately.

(Editors Note: Recently, happy events in Berlin have interjected. Besides unleashing unbridled joy and celebration, it's also triggered loads of unenlightened analysis and numerous misconceptions. Several readers have asked us for our perspective on these developments and their implications for West Germany. With delight, therefore, we open this month's letter with our views on this momentous situation before again returning to issues of international currencies and credit markets.)

AFTER THE MORTAR, NOW THE WALLS OF FINANCE AND ECONOMICS

Deeply moved by recent events in Berlin, it takes some restraint to deal calmly with the drivel of recent uninformed gossip. It seems that even the most idiotic economic interpretations have received wide acceptance within international currency markets. International analysts and traders have succeeded in transforming what appears to be a clear economic gain - and a great chapter in post-war history at that - into an overblown inflation scare for West Germany. As a result, both the D-Mark and the German bond market have been hit.

That brings us straight to the economic and financial implications of recent changes in East Germany and the influx of perhaps 500,000 East Germans (and other ethnic Germans from elsewhere in Eastern Europe) into the Federal Republic of West Germany. With no mention of any positives, sceptics claim two basic reasons for the basis of their inflation scare-mongering: government budgetary concerns and economic overheating.

A Negative is Eliminated. First of all, from a demographic point of view, the recent influx of immigrants into West Germany can only be a godsend. West German economic growth has long been belittled because many simple observers have not recognized the optical effects of negative work force growth which has been caused by low birth rates and an rapidly aging population.

Let's put things into perspective: For West Germany, an influx of 500,000 people represents population growth of 0.8%. More than half of these immigrants are of working age (between the ages between 18 and 45) thus adding well over 1% to the labour force.

Even more significant is that the East German's are highly motivated people and are well educated. In short, they are the kind of people that many other countries would be envious to attract as immigrants. In terms of the labour force, there can be no doubt that these people represent a valuable addition to West Germany's growth potential.

Budgetary Implications Overstated. While it is undisputed that an influx of qualified labour will be beneficial for economic growth, many analysts prefer to stress their concern about the possible adverse affects on the government's budget and the inflation rate.

Here again, commentary on these concerns are so unbelievable they strain credulity. Following are two sample quotes taken from market reports issued in the international press:

> Quote #1. "*The D-Mark was particularly weak undermined by the possible consequences for the West German economy from an influx of refugees from East Germany. A flood of migrants could involve the Bonn government in a considerable increase in public spending and a rise in inflation, according to some analysts.*"
>
> Quote #2. " *The dollar rose in response to the news that the Berlin Wall was to be demolished by the East German Government, but the apparent "flight to safety" in the foreign exchange markets had no impact on either U.S. bonds or stocks.*"

To be quite frank, when we compare Germany's economic and financial problems - both old and new - with those of other countries, we wonder about the balanced perspective and integrity of the authors who are playing up these problems.

Here is how we see the German budgetary situation. Due to the unexpectedly strong growth of the West German economy, tax receipts have exceeded earlier projections by a wide margin. For the first half of 1989, the total public sector deficit declined to DM 6 billion from DM 25 billion recorded in the first half of 1988. With the addition of the social insurance fund the numbers are even better: DM 5.4 billion against DM 29.2 billion.

Given this dramatic improvement in public finances, the government can, of course, easily afford some of the extra expenditures necessitated by the influx of immigrants. We think that can be easily facilitated even though the government will enact the third phase of the tax reform next year with a net anticipated reduction in taxes of about DM 24 billion.

(Note: Just minutes before our press run we learned that new official estimates for 1990 tax revenues have been released. Expected revenues have been revised upwards by DM 20 billion. By all appearances the entire 1990 tax won't even make a dent.)

Worries of Inflation Overheated. Reports of Germany's escalating inflation are also overstated. A lot of fuss has been made of the fact that the U.S. inflation rate (4.5%) is contracting towards that of Japan and Germany (3.3%).

Beware of simplistic comparisons. To begin with, one must take into account the fact that both the German and Japanese inflation rates (on a year-over-year basis) are swollen by indirect tax increases. From one perspective, the German inflation rate has not accelerated at all during the course of this year. The rate has remained at 2.2% during the last six months on a seasonally adjusted and annualized basis.

As well, when comparing inflation rates to the U.S., a number of factors have to be taken into consideration. One cannot simply ignore the weakness of the U.S. economy, and secondly, the suppressing impact of a strong dollar and a large trade deficit on the U.S. inflation... and at the clear expense of business profits no less. U.S. corporate earnings have fallen drastically recently.

The situation is very different in Germany. There one witnesses a booming economy with a strangely weak currency that has had the effect of boosting import prices. Another important difference is the behaviour of real business profits, which in Germany's case are soaring.

To quote Keynes on this key difference: "*Cheapness due to increased efficiency and skill in the arts of production is indeed a benefit. But cheapness, which means ruin of the producer, is one of the greatest economic disasters which can possibly occur.*"

Pressures on Inflation Can be Expected to Subside. There are many reasons to be optimistic about German inflation. Initially, as of January, the tax increase of a year ago will drop out of year-over-year comparisons, thus assuredly restoring an inflation rate in the two percent rate. Also, we anticipate further downward pressure on the inflation rate from a rapidly strengthening D-Mark. With a booming economy, an admirably low inflation rate between 2-3% and the highest real interest rates in the world, the comeback of the D-Mark is assured.

The other day, we asked an American friend: "Are those British and American analysts who are whipping up this hysteria about German inflation, malicious or stupid?" Our friend answered: "They are all stupid Keynesians who know nothing about supply side economics."

PROSPECTS ARE MUTUALLY BENEFICIAL FOR EAST AND WEST

All in all, an attractive economic situation as today has not graced West Germany in at least two decades. And one of the dynamic by-products of these conditions is an unparalleled financial strength. Germany's present financial strength relative to GNP and its population actually exceeds that of Japan's by a wide margin.

Therefore any talk of a burden with respect to the "opening" of East Germany couldn't be further from the truth... not to mention the snubbing of common kinship that such comments would imply. What East Germany needs is capital that can be put to productive use with its first-rate work force at the tiller. West Germany has surplus capital in abundance and also has the necessary technology and worldwide marketing expertise to help facilitate a transition of the East German economic base. As such, healthy returns for both East and West are very likely.

But, Back to Reality. There is possibly only one group in West Germany that may dislike an economic integration of East and West. That is the West German trade unions who are wary of the competitive challenges of East Germany's cheap labour.

And to this point, all of our discussion about economic integration is nothing more than a pipe-dream. Everything hinges on the major question of whether the East German authorities are willing to create the pre-conditions for the vast capital inflow from the West.

That may be a psychological and political problem for East Germany...but certainly not for West Germany. Seen in this light, all the lamenting about the adverse effects on the German economy are truly absurd. If only other countries had problems as desirable as these. And on that note, we now turn to issues of currencies and international credit markets.

AND NOW FOR A FEW DOLLARS MORE...

Even after the October gauntlet of earth-rending quakes and hair-raising after-tremors - reverberating through the stock market, corporate earnings and California - speculative fevers have hardly diminished. Obsessive and speculative psychology remains deeply entrenched. No sooner had news-wires broadcast the tragedy of an serious earthquake near San Francisco, than were brokers broadcasting their recommendations on new-found opportunities in casualty insurance stocks. Apparently, a higher earthquake risk was joyfully interpreted to mean higher insurance company premiums.

Whether its junk bonds, insurance premiums, program trading or higher leverage, its only the lure of quick-hit profits that counts. Exorbitant risks or even the possibility of calamity doesn't matter as the long as the potential for a few more dollars glimmer, whether in Europe, New York or Tokyo.

What kind of backdrop allows this brazen display of speculative mentality to breed so unchecked? It can only be two things: Either the expectation that financial and economic disasters will simply not be allowed at this stage: and secondly, the confident belief that governments have the certain capability to continue shaping their destiny.

That's exactly the situation in the U.S., where the Fed has become a toothless watchdog and can only bark at the frolicking. Everyone knows that a recession will mean certain financial hardship and everyone knows that the Fed doesn't have the appetite for being pinned with that kind of outcome. Voila! Financial arbitrageurs, take-over specialists and the like can wheel and deal with impunity.

DECEPTIVE INFLUENCES CONTRIBUTE TO THE CALM

Following earlier tumults, currency and financial markets have since resigned to a holding pattern. Volatility has been replaced by what appears to be an unusual calm. As always, the U.S. economy and the dollar commands the centre focus of attention. Everybody knows that both will land sooner or later - the question still being whether hard or over-easy.

Yet the most conspicuous thing about market sentiment is that it is completely devoid of any great anxiety. Even while U.S. economic releases show the economy to be distinctly weaker than expected, there still seems to be sufficient fodder to conjure up reasons for cheer. The stereotypical comment that concludes almost every instant economic analysis is that evidence still ordains a soft landing and that a recession is not probable. One wonders how these theories find such certain support from the current mire of economic data.

Needless to say, these happy conclusions are more a product of preconceived ideas than of the data itself. After all, the widespread conviction that there simply can't be a recession "because the Fed will not permit it" is bound to heavily colour the interpretation of economic statistics. For the moment, a soft landing ideology remains trump. And from that perspective, any weak economic data signifies the one circumstance that "paves the way" for easier money and lower interest rates -- the latter being the hopeful panacea for all of Wall Street's ills.

Lower interest rates is the rocket fuel that is supposed to launch both the U.S. bond and stock market into another heaven-ward trajectory. Even though interest rate differentials between the dollar, D-Mark and Yen will then compress even more from spreads that are already wanting, it is still expected that the splendid outlook for U.S. bonds and stocks can be enough to underpin the U.S. currency.

The Herculean confidence buttressing this bullish view doesn't just depend on the supposedly Olympian expertise and established prowess of the Fed. Two other perceptions are emboldening that view. <u>One</u> is that the U.S. economy has acquired a tremendous "bull-dozer" resilience and is simply unstoppable; and <u>secondly</u>, that the economy remains highly responsive to the monetary steering mechanism.

THE RESILIENCE OF THE U.S ECONOMY: TEMPORARY OR FOR EVERMORE?

After seven years of unprecedented economic growth, surely a soft-landing must be a remote possibility. The truth be known, quite a few recession alarms have rung over that period beginning as early as late 1984, then in mid-1986, again in the wake of the October 19, 1987 stock market crash, and yet again early this year. Like the proverbial boy crying "wolf", all these instances proved to be false alarms. When monetary policy eased and anxiety subsided, the economy had rebounded.

For many Wall Street economists, if not most, this similar vignette is being re-enacted once again, only this time with a greater coterie of doubters. A couple of months ago, after more than a year of a progressive monetary tightening, the financial environment

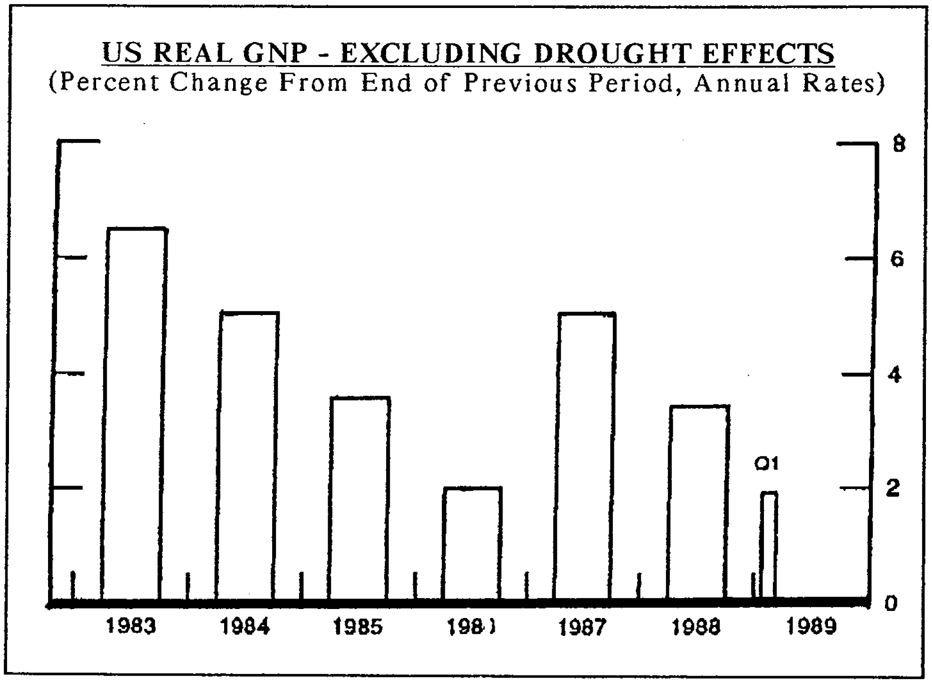
began to signal a weakening economy. But as soon as the Fed intervened (as subtle as it may have been) many forecasters were quick to change their tune.

There's little doubt that the U.S. economic expansion does appear unusually resilient. But, in our view though, such a wonder-filled feat makes it all the more important to probe why. Are there been permanent fixtures behind the phenomenon or are the reasons non-recurring and temporary? The quest for the answer, however, first leads crucial question of how the present situation differs from the past.

Let's briefly switch back to 1984 when the U.S. economy suffered its first bout of ominous weakness. Confronted with a staggeringly high annual growth rate of 10% in the first quarter of 1984, the frightened Fed pushed up the Fed funds rate to 9.5% to almost 12% between March and July. At that time, the U.S. dollar was already into the third year of a strong uptrend.

In the meantime, the economy had already begun to decelerate abruptly. In the second quarter, real GNP growth tapered down to 7.1%, then fell further to 4.3% in the third quarter and then imploded to an infinitesimal rate of only 0.3% during the first quarter of 1985.

Exhibit 1



In the early fall of 1984, as the economy sharply slowed, the Fed abruptly reversed course and yanked frantically at the tiller. Throwing all semblance of fine-tuning to the wind, it opened the money spigots as never before. By year-end, the Fed funds rate had fallen from 12% to below 8% - the lowest rate in six years. Two years of extreme monetary ease then followed, resulting in runaway growth in both money and credit.

However, before continuing our narrative any further, we ask you to carefully scrutinize Exhibits #1 and #2. The chart presents real GNP growth since 1983 while the graph portrays the erstwhile growth of money and debt. Both have been culled from the Monetary Policy Report of the Fed to Congress dated July 20, 1989.

THE HOT TRAIL OF MONEY

Let's begin with the monetary aggregates. As shown, the Fed was highly successful in boosting money and debt growth during the critical "mid-air stall" period of 1984-85.

Exhibit 2

UNITED STATES: GROWTH OF MONEY AND DEBT
(Percent, Fourth Quarter over Fourth Quarter)

Fourth Quarter to Fourth Quarter

YEAR	M1	M2	M3	Debt of Domestic Nonfinancial Sectors
1979	7.7	8.2	10.4	12.3
1980	7.4	9.0	9.6	9.6
1981	*5.2(2.5)	9.3	12.3	10.0
1982	8.7	9.1	9.9	9.0
1983	10.2	12.1	9.8	11.3
1984	5.3	7.7	10.5	14.2
1985	12.0	8.9	7.7	13.2
1986	15.6	9.3	9.1	13.4
1987	6.4	4.2	5.7	9.8
1988	4.3	5.2	6.2	8.9
Quarterly Growth Rates				
1989 1Q	-0.4	1.9	3.7	8.2
2Q	-5.5	1.3	3.1	7.4e

* = adjusted for shifts to NOW accounts in 1981
e = estimated

Money aggregates spurted to record levels with MI and debt growth leading the heat at double-digit growth rates. (*As we always point out, we regard total credit [or debt] expansion as the best and most comprehensive monetary and financial indicator.)*

So far so good. How then did this deluge of money and credit impact the real economy? One glance at the previous chart clearly shows what happened. Despite a record-breaking expansion in money and credit until the end of 1986, real-GNP growth continued to decelerate. Particularly industrial production was the most loathe to respond and remained stuck in near stagnation... edging up less than 1% in the course of these two years. Also contrary to past experience was the fact that runaway monetary stimulus was characterized by falling rather than rising inflation. How were all these enigmatic performances possible?

First of all, let's call a spade a spade. The credit expansion of that period was truly an epic inflation, and must be recognized as such, considering that credits mushroomed at annual rates of 13-14% for three years running.

THE INFLATION CHAMELEON. WHAT COLOUR IS IT?

Where possibly could all of that money have gone if not into real GNP and prices? To answer that question we need to first distinguish between the source and effect of inflation. For clarification purposes, inflation is any "excessive" increase in the supply of money and credit. The increase in the price level is an effect (one of many possible) and not the inflation itself. And in reality, money and credit inflation can produce very different consequences and symptoms, both within the price system and the real economy.

The different manifestations of an inflation are entirely contingent on how the borrowed money is employed and how it is disintermediated throughout the economy. Those sectors nearest to the source of easy new money see the most luxuriant signs of economic life, just like the exotic marine fauna in the nutrient rich surroundings of deep-sea hot water vents.

The same cause - credit expansion in excess of available savings - will display different symptoms according to which one of these principle avenues is the main repository of new

money. But critical to this analysis is an understanding of the distinctions between credit expansion, money supply and available savings.

While money and credit may be in excess, it is savings that are at the greatest deficiency. The first thing to impress is that the relationship of credit and savings now faces the most critical imbalance ever seen in the United States and several other countries. Yet, the familiar inflation symptom of rapidly rising price indexes have generally been missing. We again come back to the same question. Why has the credit expansion not reflected itself more noticeably in prices?

In short, because excess money took an entirely different route than during the 1970s. Then, most money found a counterpart in spending on current production and services. But in the 1980s, particularly after 1984, a disproportionately small amount of new money was employed in that category.

Instead, an unusually large amount of borrowed money cascaded into the purchase of paper assets (stocks and bonds) which then experienced one of the steepest price rises ever. As we've pointed out before, one of the main channels for that diversion of money was the looming trade deficit. It converted potential demand for domestic goods and services into foreign demand for real assets.

THE NATURE OF ASSET INFLATION

There are two points to be made about the resulting "paper inflation". First, it does very little to stimulate production, at best, only indirectly through its wealth effect. That explains why GNP growth languished in 1985 and 1986 despite a stimulative monetary policy. Secondly, its a type of inflation people love (Who doesn't like growing home-owner equity and investment portfolios?) and is mistaken as a sign of economic and financial health and strength. Conveniently disregarded, of course, is the debt excess that must persist to perpetuate the inflation in paper and tangible assets.

So much for the period of 1984-86. But before coming to our conclusions, what about developments since 1987 (which are also documented in the chart and table on pages 6 and 7?) What has happened since is nothing other than the exact opposite of 84/86. The domestic economy has rebounded even against a backdrop of drastically shrinking money and credit growth. Quixotically on the other hand, the economy had remained insensitive to intoxicating doses of stimulants.

SOURCES OF ECONOMIC GROWTH: SEPARATING FABLE FROM FACT.

Of course, all of this defies common logic and experience. It's no surprise then that the popular mythology of a "perpetual soft landing" found such a clinging majority of adherents, just like a life-boat in a gregarious sea of grasping economic illiteracy. The viewpoint was rationalized given the new-found resilience of the U.S. economy and that therefore tight money would not abort the recovery but rather prolong it by keeping inflation in check and buying time to dissolve the trade and budget deficit.

With hindsight, it's evident how the U.S. economy could rebound in 1987 despite a monetary tightening. What propelled the economy forward was export growth with an investment boom following in its wake. That was due to the favourable conjunction of two forces outside the immediate realm of Fed policy: first, the dollar's drastic devaluation between 1985-87; and second, bursting demand growth abroad, particularly in Europe and the Far East, which stimulated U.S. exports.

In other words, it was exports and not Fed policy that prolonged the U.S. economic expansion. The export impetus was strong enough to overwhelm the downward pressure of a progressive monetary tightening and played a key role in maintaining U.S. economic growth since 1987. Secondarily, as we have already mentioned, we cannot ignore the belated but stimulative effect of asset inflation on current consumption.

But, export-driven growth is such an unusual (in fact unprecedented) experience for America, that the economic rebound in 1987/88 has become the source of two mistaken perceptions which have found favour with Wall Street: first, as we have already mentioned, is the fabled underlying strength and resilience of the U.S. economy; and second, the fabulous ability of the Fed to fine-tune the economy through small changes in policy.

Both these perceptions, as well as the "soft landing" theory, are grossly flawed as we've shown. In the case of the Fed's purported prowess, let's not forget why the desperate pump-priming efforts between 1984-86 failed to get the economy moving again, and that in the case of the industrial revival between 1987-89 it was exports that kept the economy on track and kept it impervious to tight money. Of course, the Fed gets little attribution for any of this.

All this leads to one indelible conclusion. The diversion of credit inflation into U.S. financial markets since 1984, and the export boom of 1987/88, have created both a mirage and a false sense of security about U.S. economic and financial strength.

RECENT U.S ECONOMIC TRENDS

Early this year one again heard forecasts of imminent recession associated with bold forecasts of long-term interest rates dropping to 7% and lower. But an easing by the Fed and some better-than-expected economic data caused many to quickly change their tune from recession to expectations of a new upswing. This abrupt "U-turn" of many forecasters may be seen as a testament to the Fed's credibility as a fine-tuner.

However, looking at recent U.S. economic data, we would say that the signs of an economic weakening - in fact of a cumulative weakening - are everywhere and noticeably obvious. The most crucial aspect is that the demand aggregates that have powered the recovery since 1987 - exports and business investment - have sputtered out.

The prime economic motor of exports has stalled out since March. At the same time, progressively weakening factory orders signal a downturn in capital spending. From the fourth quarter of 1988 to the third quarter of this year, durable goods orders have declined 0.6% after having risen 12.1% in the previous year. After stripping out the surge in aircraft orders, the durable goods order trend is down sharply. Moreover, housing sales plunged 14% in September, while housing starts are at their lowest since 1982 at an annualized rate of 1,263,000 units.

The key assumption behind most of the rosy "soft landing" forecasts is that weakening domestic demand will be largely offset by further gains in foreign trade. Clearly, that is not coming true. The most disturbing part of the third quarter's GNP report was a drastic widening of the external deficit. All of the increases reflected rising imports, while exports failed to grow.

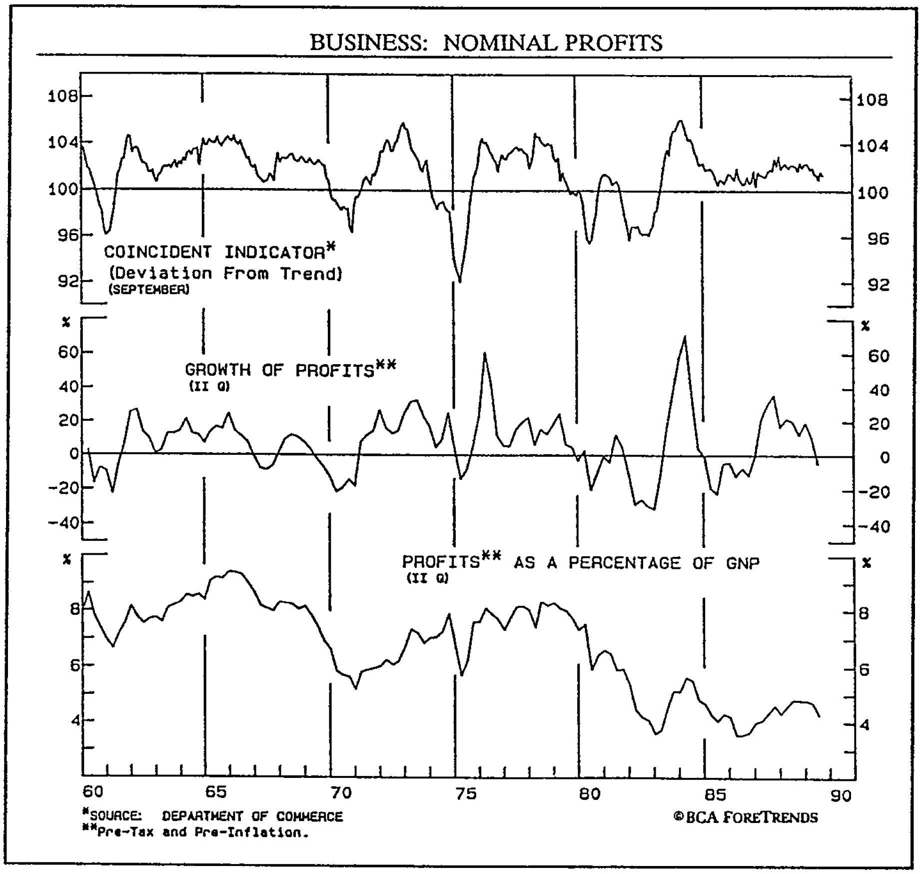
Weakness Spreads to Earnings. What's more, frequent rumours from the industrial front confirm progressive weakness .... even affecting the major "blue-chip" companies. Profit margins and cash flow are facing pressure from every quarter and are sinking under

weakening demand, rising labour costs, low or no productivity gains, sharply higher debt service burdens (due to the heavy leveraging of corporations), and downward pressure on sales prices.

While comment on the overall economy has remained quite bullish, corporate profit margins have collapsed - literally over night. That contrast has spawned the idea of a harmless "profits recession". Profits and cash flow comparisons have now turned negative during the past two quarters as well as year-over-year. The number of large companies reporting profit declines on the order of 30-40% or more is soaring, indicating extreme pressure on the bottom line.

Frightening as the numbers are, they become quite ominous when one realizes that this is occurring while the economy is still continuing to expand. One can only wonder what will happen to profits should production and sales actually decline... even if only moderately.

Exhibit 3



Our September letter had already questioned the post-1987 profit performance of U.S. corporations. We pointed out that the sharp rise in reported profits that had been fuelling Wall Street's euphoria was misleading and completely illusory. Profits were being grossly inflated by inventory inflation and a drastic reduction in depreciation allowances due to the Tax Reform Act of 1986. The view of a "profitless prosperity" that we presented makes a mockery of the current notion of a "profits recession".

Internationally, no doubt, there is a widespread perception that U.S. business has enjoyed superior profitability during the 1980s, enhanced by massive supply-side tax cuts. Precisely the opposite is true. Starkly, business profits as a share of GNP are at the lowest of the whole post-war period (please see Exhibit 3 on page 10). And that is the most natural and logical explanation why Corporate America has preferred to acquire assets through leveraging as opposed to investing in new

productive assets.

As is well known, U.S. corporations have retired more than $600 billion in equity through buy-backs, takeovers and leveraged buy-outs since 1984. Over $1 trillion in debt raised from banks, institutions, and the public markets funded these transactions. A crushing fact is that at the same time, net new productive investment is at record low of near zero.

Over the short run, the over-leveraging of Corporate America has yielded the impression of healthy results. Stock prices, obviously, rallied to confirm that impression - the Dow Jones Industrial Average having risen from a level of 880 in August of 1982 to this summer's zenith of 2780. In the long run, however, corporations will be left mired in the effluent of sharply increased debt service burdens and vulnerable to external shocks. For corporations in the manufacturing sector, interest costs as a % of cash flow have risen from 15.8% in 1984 to 25% presently. For retail trade, the same statistic trended from 23.8% to 36.3%.

Which takes us back to the Exhibit #2 on page 7 which showed the development of U.S. money and debt aggregates. While their growth rates differ sharply, they all share a steep downtrend since 1987. In that sense, they all tell the same story -- money has been getting tight.

Monetarists, of course, look at the entrails of the different M's. In our view, it's the overall growth in credit (or debt) that provides the most telling impression. There are two reasons for that persuasion: <u>first</u>, because credit is the driving force behind money growth; and <u>second</u>, because it is the only aggregate that can give us insight into the question of where the borrowing excesses have imparted their overheating boom and where, therefore, one can look for the inevitable bust to follow later.

Debt growth in the United States peaked in 1986. Since then, its rate of growth has steadily shifted downward from an annual growth rate of 13.4% to 7.4% at the end of the second quarter in 1988. As such, that rate signifies the lowest credit growth since the late 1960s ... even lower, by the way, than during the deep recession of 1980-82.

THE DYNAMIC OF ASSET PRICES AND CREDIT GROWTH

Past experience would argue that such a dramatic downturn in new lending would have contributed to a recession long ago. As already explained, it was the external stimulus of an export boom that was a major agent in preventing or delaying this outcome. The perversions of asset inflation also had a delaying effect.

There is yet another interesting question that nobody poses: What is the cause of the sharp decline in new lending? What is the constraining factor: demand or supply? After all, according to all indications, banks remain more than willing to lend. It must be true that they face less and less demand for new credit. The question is why.

Conventional wisdom would argue that credit demand has waned because interest rates are too high. In reality, the reasons are much more complex than that. You only have to look at plunging business profits, the growing obstacles to deal-making in the stock market, and the slumping property prices - including housing and commercial space - hitting one region after the other. Texas and the other oil states have been joined in the deflationary procession by Arizona, Boston, New York, Washington, Florida, and California.

For years, abundant money was borrowed to buy assets whose prices were rising. The

faster asset prices rose, the more people wanted to borrow to buy them even though money was becoming dearer. As asset price inflation takes hold, it becomes a self-reinforcing process. However, the mathematical premise for this process cannot be perpetual. Whatever the trigger or reason, it is inevitable that this process finally falters and finally collapses into reverse. As confidence in rising asset prices wanes, borrowing for their purchase declines, too - and soon asset prices begin to slide.

THE RACK NO LONGER CONTROLLED BY THE MONETARY PINION

And as a rule, the higher asset prices soar, the harder they fall. It is a fact that all cyclical upswings caused by monetary inflation start out with rising asset prices, just as all recessions start out with falling asset prices. The only thing new in the present U.S. experience, is that such a widespread collapse in property prices has occurred without a visible credit crunch. In our opinion, the simple explanation is that past debt excesses have gone to such extremes that asset values now collapse under their own debt-logged weight.

If that is already true, a rather frightening conclusion follows: Should a downturn happen without a credit crunch, then how can the Fed arrest it by easing credit further? From that perspective, the minor reductions in Fed funds rate must be seen as insignificant.

SUMMARY CONCLUSIONS

It's only a question of time before the same spectre in the property market hits the U.S. stock market. It's as clear as day that the whole bull market from 1984 to 1987 was based on a "deal mania" that was fuelled and force-fed by the easy and free credit made available to raiders and corporations.

So far, two differences explain why stock prices have held up better than property prices. One reason is that the stock market is infinitely smaller in size and, therefore, more easily prone to manipulation. The other reason is that the stock market has a greater degree of foreign participation - a source of demand that can be greatly helped by visions of a strong dollar - another result of high credit inflation.

With respect to events surrounding East and West Germany, one last point: It has been easy to bury Stalin but it will be much more difficult to bury Marx. An economic assimilation, no doubt, will face many psychological barriers.

Above all, the mirage of well-being in the United States is a dangerous delusion. The whole visage of a "soft-landing" and all the other comforting theories are all attributable to the deep ignorance of the effects of asset inflation and supply-side economics.

Given the beginning crumble of property prices in the U.S., there is soothing talk about the virtues of "rolling deflation". It is joyously received as anti-inflationary and healthy. We can only say that to confuse price inflation with that of asset inflation is grossly ignorant! Imagine the daunting challenges that will face the Fed given the steepening financial risks of asset deflation and the persistent pressures of price inflation.

(In the next letter we plan to focus on two topics poorly understood by markets today. Firstly, we will explain the important differences between asset inflation, asset deflation, and price inflation and deflation. Secondly, we also hope expose the nefarious effects of asset inflation using several countries as illustrations.)

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Muehlegasse 33, CH-8001 Zuerich, Switzerland

Annual Subscription:
SFr. 600.–/US-Dollar 400.– for subscribers outside Europe.

Languages: German/English